

Why the Madoff Scandal Led to Increased Interest in the Development of Standards for the Reporting of Investment Management Performance

Investment managers live and die by the performance numbers that they produce. Good numbers, that is numbers that beat the indexes, can mean more business. Bad numbers mean less business, even sometimes the death of the firm. Consequently, investment managers, recognizing the power of the numbers to make or break their business, are often tempted to report performance numbers that are inaccurate.

Intelligent skepticism toward reported numbers predated the revelations of Bernie Madoff's strategy, but surely the breaking of the Madoff scandal accelerated interest in numbers that were accurate and representative of a firm's performance. The first step in getting honest numbers is to make sure that the custodial and reporting functions are separate from the investment management function. In the Madoff case, these two functions were both controlled by Madoff, giving him the freedom to create or report any numbers that he wished to report.

The Madoff scandal broke on December 12, 2008. The Wall Street Journal explained how Madoff created and reported the fictitious performance numbers that he disseminated to his clients:

[Bernard Madoff](#) is the sole owner of the firm [Bernard L. Madoff Investment Securities LLC], which he started in New York in 1960. He built it into a successful market maker, which means it facilitated securities trades by serving as a middleman between [institutional investors](#). Mr. Madoff helped develop the [Nasdaq stock market](#) and he once served as its chairman. He also helped advise the [Securities and Exchange Commission](#) on securities-trading rules.

Under the radar, Mr. Madoff also operated an investment-advisory business that drew in billions of dollars from institutional investors, wealthy individuals and some middle class individuals who invested through third-parties, or 'feeder funds,' such as those offered by Tremont Capital Management and Fairfield Greenwich Advisors, which had more than \$10 billion in client money invested with Mr. Madoff's firm. The investment-advisory part of the firm, which was located on a different floor from the firm's market-making business in a midtown Manhattan skyscraper nicknamed the [Lipstick Building](#), had about 20 employees. Investigators are looking at whether the two businesses were connected.

Mr. Madoff's firm apparently kept his funds in-house, which may have made it easier to conceal the alleged fraud. [This is a truly gigantic understatement that the Journal makes.] Also, Mr. Madoff didn't register the business until 2006, after the Securities and Exchange Commission's enforcement arm began an investigation based on claims by a whistleblower that Mr. Madoff was running a [Ponzi scheme](#). (The agency didn't find evidence of fraud, though it said Mr. Madoff 'did not fully disclose to the examination staff either the nature of the trading conducted in the [investment-advisory business] or the number' of client accounts.)

During the period of the alleged fraud, Mr. Madoff told clients (through their account statements) that he was using a fairly common options-trading strategy to generate modest but steady returns. The strategy involved buying stocks, while also trading options—which grant the right, but not the obligation, to buy or sell securities at pre-established prices in the future—in a way designed to limit losses on the shares. Many investors say they were told they had gains of about 10% for many years.

People who analyzed client statements said Mr. Madoff's firm couldn't have bought and sold the options he claimed because those totals would have outstripped total trading volume those days.

A person familiar with the situation said investigators believe Mr. Madoff initially had a [trading strategy](#) that failed, and that he had made very few, if any, stock or options trades for clients over the years. Instead, the operation consisted of taking money in from new clients and paying it out to existing clients, said people familiar with the matter. Over the past year or so, as [institutional investors](#) and other wealthy clients were getting bruised by a sharp downturn in the stock market, the amount of redemptions probably rose too quickly to sustain the alleged Ponzi scheme, which may have begun as early as the 1970s, these people said. (“Q&A on the Madoff Case.” *The Wall Street Journal*, March 12, 2009).

As anyone who has ever been in a locker room or clubhouse knows, men and women like to exaggerate their achievements, boasting, in the case of their experience with investing, of their successes, and frequently not mentioning their disappointments and defeats. Their stories are often not representative of the facts. The Global Investment Performance Standards (GIPS), by requiring the money manager to include all accounts in the averages he reports, ensure that the numbers are correct, that there is no locker-room exaggeration, and that the numbers are representative of performance and therefore are statistically significant

Bernie Madoff practiced deceit, and he was excellent at it. He understood that if he could make his strategy opaque, mysterious, and difficult to understand, the naïve and the unsophisticated would think that he was ingenious. This strategy of obfuscation is of course diametrically opposed to the strategy that Warren Buffet practices, that is to execute investment in an uncomplicated manner and to communicate with clients in the clearest possible way.

Even before the Madoff scandal broke, there was pressure from the CFA Institute, the global governing authority of the profession, to standardize the reporting of investment results. The CFA Institute produced the Global Performance Investment Standards, which require that the investment manager undergo an audit and verification before he can claim that his numbers are accurate and representative of performance.

We are extremely proud of our investment performance and we wanted to be sure that our clients, present and prospective, understood that our reporting methods met all of the Global Investment Performance Standards.

To achieve this assurance, we hired The Spaulding Group, Inc., one of the most respected auditors and verifiers of GIPS, to audit and verify our record. The report below shows that The Spaulding Group issued an unqualified opinion, dated July 18, 2009, on our performance numbers for the five-year period that began on January 1, 2004, and ended on December 31, 2008.

The Spaulding Group, a CFA Institute member firm, has been performing verifications since 1992. David Spaulding has written several textbooks on investment performance measurement and was a member of the boards responsible for developing the GIPS in 2006 and their predecessor standards in 1992.

The Spaulding Group audited our performance numbers for a five-year period (the time period required by GIPS) from January 1, 2004 through December 31, 2008. The Spaulding Group then performed an examination which was conducted in accordance with the guidelines provided by GIPS, including the guidance statements for verification. **We offer a link to this opinion below:**

http://www.fredricerussell.com/marketing/Report_of_Independent_Verification.pdf

The performance presentation on our website shows the performance of our primary equity composite compared to the benchmark index chosen for us by The Spaulding Group, Inc. In the case of the Fredric E. Russell Investment Management Co., our primary composite is comprised of client accounts that contain companies headquartered in the United States and with all equity accounts having a certain minimum market value. The largest percentage of our market capitalization dollars are in the Standard & Poor's 500, so we, at the direction of our auditor, The Spaulding Group, Inc., use the Standard & Poor's 500 as our benchmark. As of August 4, 2010, nine of our companies, or 56.25%, are included in the Standard & Poor's 500; an additional company, Dolby Laboratories Inc., is not included in the Standard & Poor's 500 but qualifies as large-cap under Standard & Poor's definition and similar to the other nine companies in market capitalization.

For a client account to be included in a composite, the account, in the opinion of the auditor, must be governed by the same strategy as the other accounts or portfolios in the composite. All accounts in our Primary Equity Composite are comprised of common stocks of publicly traded companies whose headquarters are in the United States. Many of these companies derive a significant percentage, and often a majority of their revenues, abroad, but their corporate base is in the United States. All accounts are managed with the same equity strategy.

As you can see in our GIPS performance presentation, we have decisively outperformed the Standard & Poor's 500, as well as the two other indexes that are comprised of companies of similar capitalization or market size that comprise our client portfolios.

Madoff controlled the custodial and reporting client functions, as well as investment management functions. Consequently, he could produce or fabricate numbers that would excite and please his clients, even if these numbers were fictitious, and even if they exaggerated favorably, as they usually did, the actual or real results that his investment management arm produced. Madoff leased headquarters in a Manhattan office tower, with the investment arm on the eighth floor and the custodial arm on the sixth floor. One lesson from the Madoff fraud is inescapable: to protect the investor, separate the custodial from the investment management function. For example, we use Advent Software to keep track of all of our client positions and to track our performance internally. Charles Schwab is the custodian and record keeper for our clients' assets. Thus the investment performance and the custodian and reporting functions are separate.